



Greater Effectiveness with Policy and Institutional Reform

Background

MCC was established in 2004 during a period when literature on ‘aid effectiveness’ was flourishing. MCC’s founding principles were designed with the intent of making MCC a leader in applied aid effectiveness principles: a data-driven selection process to support relatively well-governed countries with a good policy environment and relative control over corruption; transparent, results-focused investments with accountability mechanisms built-in; and a focus on strong country ownership with joint project development informed by local knowledge and broad stakeholder consultation. Work by Dollar and Burnside (2000), Radelet and Clemens (2004), World Bank chief economist Nick Stern (2002), Jeff Sachs (2005) and others was embraced by aid agencies hungry for evidence on aid effectiveness. Though much of this research was debated, it has had a generational impact on aid agencies. And it set in motion much of the rationale for creating MCC as a new, independent USG development partner.

In the intervening years since the early 2000s, the literature on aid effectiveness has largely moved beyond multi-country regression analysis of development outcomes conditioned on aid and country attributes. Two trends are evident. First, there was tremendous growth in experimental and quasi-experimental evaluation of the impacts of policy and program interventions on development outcomes. This helped feed the drive for greater rigor and hard evidence on development outcomes and understanding causal links to policy and program design. In line with the works of the Poverty Action Lab, DIME, 3iE, etc., impact evaluation dominated MCC’s early commitment to rigorous assessment of its investments, with roughly half of MCC projects assessed through impact evaluations. This has gradually waned as limitations of impact evaluation methodology in terms of its applicability to many MCC interventions, and its generalizability across diverse contexts, sectors, and projects became more evident.

A second trend, evident in MCC’s early focus on the policy environment, is increased recognition of the role of institutions driving sustainable growth and effective aid. Work by Acemoglu and Robinson (2005) argued that “differences in economic institutions are the fundamental cause of differences in economic development” operating through the distribution of power in society and influencing the incentives and constraints that face economic agents. Institutions that adapt to changing economic circumstances and effective reforms that shift incentives can deeply impact the sustainability of growth and resilience (Rodrik 2007; Fukuyama 2014, etc.). This literature aligns with MCC’s emphasis on better governance, as policy and institutional performance has prominently featured in MCC’s eligibility and selection process since its

founding. However, bringing policy and institutional reform (PIR) into the process of project identification and design has been a complex process. As appreciation of the potential contribution of PIR to project outcomes grows, MCC has increasingly pursued PIR as a complement to its compacts' infrastructure projects and as the direct focus of its threshold programs.

MCC's Experience with Policy and Institutional Reform

MCC builds PIR into both compacts and threshold programs but in different ways and facing different opportunities. Consistent with MCC's mandatory investment criteria, PIR elements must address root causes of an identified binding constraint to growth. Under its compacts, MCC often accompanies its large infrastructure projects (power, water and sanitation, transport) with PIR elements focused on improving the asset's operation and management as well as the surrounding regulatory and policy environment. In Malawi's first compact, for example, MCC coupled a large power infrastructure investment with critical reforms to the entities that struggled to manage its operations, maintenance, financial management, and tariff collections. Similarly, MCC's water compact in Mongolia features legal, regulatory, and institutional reforms to enhance the capital Ulaanbaatar's water and sanitation infrastructure. MCC conditioned funds disbursement on planning and demonstrated progress toward full cost recovery in the water and sewerage authority, chemical discharge controls, and implementation of a water quality rating system.

In some instances, MCC pursues PIR opportunities beyond the immediate infrastructure investment. Here, the benefits and impact are more indirect but potentially very large, particularly with so-called "stroke of the pen" policy changes that immediately reshape a policy environment. In Niger's agriculture-focused compact, for example, investments focus on irrigation and transport, but the program critically conditioned disbursements on the reform of fertilizer distribution and opening of the fertilizer market to all private firms.¹ Eliminating distortive and welfare-harming tariffs has already resulted in record entries of fertilizer shipments into the country, and the implications for productivity and income, while still too early to report, are easy to imagine.

MCC Threshold Programs (THPs) focus primarily on policy and institutional reform work. With smaller budgets, ranging from \$20-\$60 million, THPs present an opportunity for countries that are not yet eligible for a compact to demonstrate their commitment and capacity to pursue PIR in areas that are binding constraints to growth. A country's engagement through the THP supplements its performance on the scorecard when assessing compact eligibility. In a broad sense, countries often view THPs as a first engagement toward large grant-based assistance. THP development relies on a similar analysis of the binding constraints to growth. But, given the smaller budgets and the nature of the activities, THPs are not subject to MCC's cost-benefit analysis. Unlike compacts they do not need to meet the required minimum 10 percent economic rate of return, both for infrastructure and associated PIR. As such, opportunities to pursue more innovative, experimental interventions arise. In the case of The Gambia's THP, signed in November 2021, the program will center on improvements in governance and operations within the national electricity utility, emphasizing a "learning by doing" adaptive approach that tasks teams of different stakeholders to uncover and solve problems across an array of regulatory, administrative, and operational areas. The planned THP for Ethiopia focused on enhancing the country's

trade profile to help generate foreign exchange, but program development been discontinued (see box).

Pursuing Trade Growth in Ethiopia. MCC worked with Ethiopia to develop a Threshold Program that aimed to develop a comprehensive strategy for trade facilitation and deregulation. In close coordination with the government's Ministry of Trade and Industry, the designed program reflected the country's desire to enter new markets arising in the African Continental Free Trade Area. Efforts centered on convening relevant Ethiopian decision-makers across different offices to galvanize interest in a more coherent and all-of-government approach to trade. Products of focus centered on agricultural commodities, including beans and leather goods, as well as more high-profile commodities like coffee and textiles. Though MCC discontinued development of the Threshold Program due to events in Ethiopia, interest on the part of the government remains keen to deepen its capacity in this regard.

MCC's commitment to address PIR priorities notwithstanding, several challenges arise in terms of configuration, implementation, valuation, and conditionality.

Configuration of PIR. Most of MCC's PIR-related support flows towards embedding advisors, digitalization, or training. Given MCC's five-year time limit, more prolonged engagement, often necessary for achieving fundamental and durable institutional transformation, has not featured prominently in its efforts. MCC has experimented with problem-driven iterative adaptation approaches (PDIA), but to date these activities have been confined to project preparation. The Solomon Islands and The Gambia THPs will be the first to carry the PDIA approach on to the implementation stage.

Implementation. MCC generally designs PIR to accompany priorities in infrastructure-related investments, works of engineering that are at once concrete, measurable, and manageable within a five-year completion period. PIR efforts, being more qualitative and less observable, are less amenable to measurement, and discretizing institutional reform on a Gantt chart that fully captures sequences and dependencies can be tricky and imprecise. MCC's five-year timeline also limits the extent to which broad-based PIR can unfold. Consequently, PIR receives less attention and often occurs later in the compact design process.

Methodological challenges to valuation. Within compacts, PIR interventions can only proceed following an analysis of costs and benefits. MCC economists have struggled with the absence of quantified data on PIR and have felt uneasy about parameterizing benefit streams from policies or institutional practice. To compensate, they often assume that either (1) PIR represents *quantifiable costs but unquantifiable benefits*, treating PIR as a cost, or (2) the benefits are effectively subsumed in optimal O&M practice, maintaining infrastructure assets and associated service flows through the projection period. The business-as-usual-counterfactual assumes poor O&M and degradation of assets. In the first case, allocating funds for PIR acts effectively as a tax on the investment, lowering its ERR. In the second case PIR is effectively a subsidy, boosting the ERR by removing known challenges to O&M practice, e.g., fiscal control, technical capacity, managerial oversight. Currently, efforts are underway to more explicitly capture PIR benefits.

Conditionality. Conditionality is often critical to implementation. MCC regularly introduces "conditions precedents" to bring key PIR-related outcomes into alignment with project implementation. These include requiring actions prior to compact entry into force (e.g., parliamentary ratification of the

compact), as well as pre-conditions for specific procurements or disbursement authorization. Despite being critical to program success, establishing government and broader stakeholder buy-in for such changes, can be risky, particularly given the interests of actors under the status quo.

MCC's practice stands in contrast to multilateral development banks (MDBs) which often address PIR through budget support instruments and longer-term engagement with public and private counterparts. Such an approach permits deeper and more persistent dialogue around institutional practice but may be less well-integrated and targeted to specific infrastructure-relevant reforms. Moreover, MDB-funded infrastructure projects frequently embed PIR elements but forego any cost-benefit modeling. MDB evaluations suggest that combining PIR with budget support and/or infrastructure projects has typically had greater success in achieving reforms than PIR carried out in isolation, and this may owe to an alignment of incentives across infrastructure related line ministries and policy and budget-oriented Ministries of Finance and Planning.

Questions for the EAC

These challenges raise several questions for the EAC regarding MCC practice to strengthen sustainability and impact of development programs.

- **How can MCC improve its PIR efforts within its infrastructure-centric model for economic development?**
 - `. Does the development literature point to certain kinds of PIR as more successful in achieving growth than others (for example, capacity building versus legislative reform, or policy reform as distinct from institutional reform)? What are the lessons from use of conditionality in other agencies?
 - `. Beyond timelines for reform and country ownership, what risks do development agencies face when considering PIR interventions, and which ones should MCC work to mitigate?
 - `. Does evidence support a 'problem driven iterative adaptation' approach to addressing the complexity posed by PIR reforms?
 - `. Does MCC's strict 5-year engagement pose a greater risk of poor coordination with other donors and argue for greater donor partnership in PIR work? Could a strict time frame (use or lose the grant) provide incentives to accelerate reform?
- **How could MCC pursue broader PIR *independent of a particular brick and mortar investment*?**
 - `. Besides threshold programs and conditions precedent in compacts, what other instruments and modalities can or should MCC utilize to advance PIR goals?
 - `. Budget support with its associated policy dialogue and design mechanisms as offered by MDBs falls outside of MCC's statutory scope for interventions. Are there alternative instruments, such as a results-based financing (RBF) type mechanisms MCC might use to advance discrete elements of PIR?
 - `. How should MCC consider PIR to advance broader issues, for example to promote regional (cross-country) integration? Are there areas where PIR could better address worsening income inequality and promote inclusive growth, an MCC objective? Should the agency consider THPs for such PIR elements?
- **MCC aspires to rigorously apply cost-benefit analysis to all projects, and its investment criteria require meeting a 10% ERR hurdle rate.**

- ` . What guidance exists that could help address risks around incorporating PIR in cost-benefit analysis models?
- ` . Are there alternative methods for measuring costs and benefits of PIR projects that could augment cost-benefit modeling?

Endnotes

1. The condition read, “The GoN will reform fertilizer distribution and requires the GoN to open the fertilizer market to all professional private firms by mainly reforming the current procurement process, adjust the pricing strategy to be market-oriented, and commit to a fertilizer subsidy exit strategy that leaves in place a focused program meeting crisis needs of the most marginalized”.